APPENDIX A

In the United States District Court for the
Eastern District of Missouri
Eastern Division

Elott H. Raffety Farms, Inc.,
Plaintiff,
vs.
United States of America,
Defendant.
} No. S 71 C 64.

Order of Judgment

(Filed December 27, 1973)

A memorandum of the Court filed this day in this action is hereby incorporated in and made a part of this order.

It is Hereby Ordered, Decreed and Adjudged that the plaintiff Elott H. Raffety Farms, Inc., recover of the United States the income tax refund to which it is entitled pursuant to the memorandum of the Court filed this day; and

It Is Further Ordered that the defendant, within thirty (30) days of this date, compute the amount of income tax refund due the plaintiff pursuant to this decision, which recomputation will be proposed as the amount of judgment recovery in this action. Dated this 27th day of December, 1973.

H. KENNETH WANGELIN
United States District Judge

APPENDIX B

In the United States District Court for the
Eastern District of Missouri
Eastern Division

Elott H. Raffety Farms, Inc.,
Plaintiff,
vs.
United States of America,
Defendant.
No. S 71 C 64.

Memorandum

(Filed December 27, 1973)

This action was commenced by the plaintiff Elott Raffety Farms, Inc., against the defendant United States of America for the refund of income taxes paid in the taxable years ending March 31 of 1964, 1967, 1968, 1969 and 1970. Plaintiff claims deductions totalling $222,000.00 "advanced" by it to a farming enterprise in the Republic of Mexico. The enterprise succumbed to adverse weather and other growing conditions in 1966 and 1967. Timely claims for refunds were filed and denied by the Internal Revenue Service: 28 U.S.C. § 7422 (a). The Court has jurisdiction of the subject matter of the action pursuant to 28 U.S.C. § 1346(a)(1). This action was tried to the Court sitting without a jury.

The plaintiff is a corporation that was organized in 1962 under the laws of the State of Missouri. Plaintiff, during the times material to this action, was and is engaged in the business

of farming, and it has its principal place of business in Mississippi County, Missouri.

In Missouri in early 1965 plaintiff, through its president and principal stockholder, Elott H. Raffety, agreed oraly with L. D. Joslyn, a Missouri attorney, and Rolwing-Moxley Company (hereinafter "Missouri partners") to conduct farming operations in Mexico. They agreed that plaintiff would own a one-half interest in the enterprise, and that Joslyn and Rolwing-Moxley Company would own one-quarter interests each. They agreed to share in the profits and losses of the enterprise according to their interests. They considered themselves general partners. They further agreed that, although each partner would have an equal share in the management and control of the enterprise, the farming operations were to be administered or managed in Mexico by Elott H. Raffety.

The decision to farm in Mexico originated with L. D. Joslyn. Joslyn owns a one-third interest in Rolwing-Moxley Company, a corporation engaged in ginning cotton and other farm products. Between 1960 and 1965 he visited Mexico and observed that cotton was being grown there in increasing amounts. He concluded that the cotton he observed was healthy and of good quality, and that the best cotton growing areas should produce from 1¾ to 2 bales per acre. Since the prospects of Rolwing-Moxley Company in the Southeast Missouri cotton industry were considered poor, he interested Raffety and Rolwing-Moxley Company in forming a partnership for the purpose of farming in Mexico.

In the years 1961 through 1966 plaintiff owned four separate parcels of land consisting of 685.71 acres, 126 acres, 1290 acres, and 440 acres. Prior to 1965 approximately 5% of the 685.71 acres was used to grow cotton, and 1% of the remainder was used to grow cotton. In 1965, before *El Sombrero S. de R.L.* was set up, no cotton was raised on plaintiff's land. Joslyn

had been engaged in farming since 1941, owning over 2,500 acres on part of which he grew cotton between 1961 and 1965.

The three partners employed Humberto Gutierrez Saldivar, a lawyer licensed in Mexico, to take whatever steps were necessary to enable them to farm there legally. Joslyn had conducted legal business in Mexico before, but he had no specific knowledge of business organizations under Mexican law. In 1965 Saldivar organized *El Sombrero Sociedad de Responsibilidad Limitada* (S. de R.L.), a limited responsibility company, to conduct the farming business. The organizational articles of *El Sombrero S. de R.L.* provided, *inter alia*, as follows:

> 1. The company's general purpose was the exportation of agricultural products. The company was empowered to lease ground, to process agricultural products, and to do all lawful acts related to the exportation of agricultural products.
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> 2. The duration of the company was to be twenty years.
>
> 3. The business capital was fixed at 3,000,000 pesos, of which 2,000,000 pesos were to be contributed by Luis Vargas Nunez; 500,000 pesos by Juan Facundo; and 500,000 pesos by Fernando Marino Villela.
>
> 4. None of the members of the company were able to . . . . . [blank space in documentary evidence] their shares or any portion thereof without the consent of the members represented, or at least three-fourths of the business capital.
>
> 5. Transfer by inheritance of the shares of deceased members required the consent of the majority of the remaining members. Otherwise, the shares of deceased members were to be liquidated and the proceeds distributed to the heirs.

> 6. The number of members was limited to twenty-five.
>
> 7. The business was to be conducted by one named administrator, Luis Vargas Nunez.
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> 8. The members were required to meet annually.
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> 9. An annual accounting was required.
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> 10. The death or separation of any members was not cause for dissolution of the company.
>
> 11. The liquidation of the business was to be administered by the manager or a person designated by the assembly of members.
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> 12. The fiscal year corresponded to the calendar year.

Joslyn and Raffety believed that this *Sociedad de Responsibilidad Limitada* was in the nature of a limited partnership that would operate as a straw party or agent of the three partners in Missouri. They believed that such an organization was required before they could farm on Mexican land. Saldivar never informed them of any other legal significance of the *S. de R.L.*, except that it was similar to a limited partnership. Also, he never furnished them any memoranda of law respecting the *S. de R.L.*

No conveyance or assignment of any interest in *El Sombrero S. de R.L.* was ever made to the plaintiff. The *S. de R.L.* never issued stock. No meeting of its members was ever held in Mexico. Raffety was acquainted with the three persons whose names appear as organizers in the articles. However, they did not contribute any capital to the business nor did they perform any services for the company for which they were paid by plaintiff. Only Raffety managed the farming operations under the direction of the three Missouri partners. However, he did conduct the business operations under the name of *El Sombrero S. de R.L.*

Raffety moved to Mexico in April of 1966 and commenced farming operations. Approximately 7,300 acres of cotton were planted from June to August, 1966. A good stand of cotton came up and some of it was open when hurricane Inez hit in the first week of October. Before the hurricanes came, Raffety estimated the crop would average 1 or 1½ bales per acre. After the hurricane, less than 600 bales were harvested.

In 1967, Raffety again planted the 7,300 acres in cotton. The seasonal rains did not occur that year and the planting was to dry ground. In August some rain fell and the crops came up. Shortly thereafter, hurricane Beulah hit and drowned much of the cotton. Grass and weeds grew up and the fields could not be cultivated because of the moisture. Practically all of the 1967 crop was lost. In November and December, 1967, Raffety planted safflower. This crop was harvested in April and May, 1968, and the farming operations thereafter ceased.

In the fiscal years ending March 31, 1967 and 1968 plaintiff advanced $200,000.00 and $22,000.00 respectively, to the farming operation. Joslyn and Rolwing-Moxley Company each advanced $100,000.00 and $11,000.00 during these same years. In exchange for this money, no notes were issued. There were no provisions for interest. No interest was paid. There was no fixed maturity date for the repayment of the money. No security was established. And no money so advanced was required to be repaid to the plaintiff. None of this money was recouped.

Plaintiff contends that these "advancements" are either (1) ordinary business expenses deductible from income pursuant to § 162(a) of the Internal Revenue Code ("I.R.C."), 26 U.S.C. § 162(a)[1]; (2) operating expenses deductible from income under § 165(a) of I.R.C., 26 U.S.C. § 165(a)[2]; or (3) bad debt losses deductible from income under § 166(a)(1) of I.R.C., 26 U.S.C. § 166(a)(1).[3]

[1] The relevant portion of § 162(a) I.R.C. provides as follows:

(a) *In general.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, or property to which the taxpayer has not taken or is not taking title or in which he has no equity.

[2] Section 165(a) I.R.C. provides as follows:

(a) *General rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

[3] Section 166(a)(1) I.R.C. provides as follows:

(a)(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

The United States contends that:

1. The taxpayer sustained capital losses under §165 I.R.C. for the years ended March 31, 1969;

2. The "advances" were contributions to capital, not loans, and therefore, not deductible under §§162 or 166 I.R.C.;

3. The Mexican business organization through which the taxpayer operated, *El Sombrero S. de R.L.*, was an association taxable as a corporation; and,

4. The farming operations were non-deductible capital expenditures made for the acquisition of land.

Any income tax deduction is a matter of legislative grace, the right to which the plaintiff has the burden of proving. *Interstate Transit Lines v. Commissioner of Internal Revenue*, 319

U.S. 590, 593 (1943); *Industrial Aggregate Company v. United States*, 284 F.2d 639, 644 (8th Cir. 1960).

The first issue raised by the parties is whether *El Sombrero S. de R.L.* is an association taxable as a corporation. 26 U.S.C. §7701(a)(3). Under the facts of this case, if it is not so taxable, then it is taxable as a partnership and the subject deductions may be claimed ultimately by the Missouri partners. A label affixed to a business organization by local law does not determine its status under the Internal Revenue Code. Rather, the Code determines how it is to be denominated upon a proper consideration of the legal relationships which characterize the subject organization under local law. Treas. Reg. §301.7701-1 (c). The Code regulations recognize six major characteristics ordinarily found in a pure corporation which distinguish it from other organizations, i.e. (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Treas. Reg. §301.7701-2(a)(1). transferability of interests. Treas. Reg. §301.7701-2(a)(1). Since both corporations and partnerships usually involve characteristics (1) and (2), only characteristics (3)-(6) are to be considered when deciding whether an organization is taxable as a corporation or as a partnership. Treas. Reg. §301.7701-2(a)(2). And "[a]n unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics." Treas. Reg. §301.7701-2(a)(3).

Although this *S. de R.L.* is an association taxable as a corporation under the Code, the Court is of the opinion that it must be disregarded for tax purposes as it was but a passive entity.

In *Jackson v. Commissioner of Internal Revenue*, 233 F. 2d 289, at 290 (2nd Cir. 1956), The Court stated as follows:

> "A corporation may not be disregarded in respect to taxation if, *inter alia*, a bona fide intention in creating it was that the corporation itself should have some real substantial business function, or if it actually engages in business; on the other hand, the corporation may be disregarded, in the absence of such an intention or activity. The intended or actual business functioning of the corporation itself, not the taxpayer's aim to be accomplished via the corporation, is the test." (footnotes omitted).

The Court affirmed the Tax Court ruling that, although the taxpayers had as a purpose for the existence of the subject corporation's insulation from liability to creditors, these corporations performed no business function and were to be disregarded for tax purposes. *cf., Paymer v. Westrich Realty Corporation*, 150 F.2d 334 (2nd Cir. 1945).

The *El Sombrero S. de R.L.* was not organized for the purpose of avoiding taxes. Rather, it was organized upon the advice of Mexican legal counsel to allow the Missouri partners to farm in Mexico without being in violation of Mexican law. However, the *S. de R.L.* performed no substantial business function. The organization was never capitalized nor managed according to the provisions of the organization articles. The farming operations were controlled by the Missouri partners and managed locally by Elott Raffety. When the farming business was liquidated in the Spring of 1968, the liquidation was not carried out by the nominal administrator, Nunez. There were no annual meetings or accountings ever held as required by the organization articles. The only apparent purpose of the organization was the use of its name by the farming operation. None of the Missouri partners were ever subscribers to the *S. de R.L.* articles, nor did they ever own any legal interest in the organization.

Under § 162 I.R.C. a farmer is entitled to deduct from gross income the ordinary and necessary expenses in carrying on the

business of farming. Treas. Reg. § 1.162-12. *Clement v. United States*, 331 F. Supp. 877, 882 (E. D. N. Car. 1971). Each member of the Missouri partnership had been engaged in the business of farming in Missouri when they expanded their farming operations into Mexico. Defendant seeks to distinguish plaintiff's Mexican cotton growing operations from its earlier American farming by showing that, in the years immediately proceeding 1966, plaintiff grew cotton on only small portions of its land. However, the evidence does not show any significant difference between the operation of the American and the Mexican farms which would give merit to defendant's distinction.

Under § 162 an expense is "necessary" if it is " 'appropriate and helpful' for 'the development of the [taxpayer's] business.' " *Commissioner of Internal Revenue v. Tellier*, 383 U.S. 687, at 689 (1966), citing *Welsh v. Helvering*, 290 U.S. 111, at 113 (1933). The Court in *Tellier* further stated that "[t]he principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset." 383 U.S. 689-690. The defendant herein asserts that the subject monetary advances were contributions to capital and not expenses under § 162. The Court disagrees.

In United States v. General Bancshares Corporation, 388 F. 2d 184, at 187-188 (8th Cir. 1968), the Court stated:

> "Generally capital expenditures occur when an improvement or betterment is made to a capital asset (§ 263 I.R.C.) or an expense is incurred in the purchase or sale of a capital asset or the collection of capital proceeds. See 4A Mertens, Law of Federal Income Taxation, (1966 Rev.) § 25.20, Capital Expenditures . . . The precise slot into which a given expense is to be placed is at times extremely difficult

> to determine, as the expenses will often partake of the nature of both current and capital items. It, therefore, becomes necessary to view the expenses in context with the transaction in which they are incurred to assess their proper characterization."

Stated another way, "a business expense is tested by its normalcy and soundness considered in light of the taxpayer's trade or business." *Wells-Lee v. Commissioner of Internal Revenue*, 360 F.2d 665, 669 (8th Cir. 1966); e.g. MFA Central Cooperative v. Bookwalter, 286 F. Supp. 956, 961 (E.D. Mo. 1968).

The Court has examined the evidence and finds and concludes that the amounts advanced to the Mexican farming operations by the Missouri partners were expended for labor, for the lease —not the purchase of land for planting, cultivating and other expenses normal and usual to farming operations. These were not capital expenditures but were deductible under § 162(a) I.R.C. Therefore, the Court finds it unnecessary to treat plaintiff's alternative claims to deductions.

The parties have stipulated that, should the Court find that the Mexican farm land was acquired by lease, $100,000.00 of the lease payments must be amortized over a five year period.

The parties have further stipulated, and the Court will so order, that they shall have thirty (30) days from this date in which the defendant will recompute the amount of refund due to the plaintiff, pursuant to the principles of this decision, and that the resulting recomputation will be the amount of the judgment to be entered.

Dated the 27th day of December, 1973.

/s/ HON. H. KENNETH WANGELIN
U. S. District Judge

APPENDIX C

United States Court of Appeals
for the Eighth Circuit

No. 74-1392

Elot H. Raffety Farms, Inc.,
Plaintiff-Appellee,
v.
United States of America,
Defendant-Appellant.

Appeal from the United States District Court for the Eastern District of Missouri.

Submitted: November 15, 1974

Filed: February 26, 1975

Before Gibson, Chief Judge, Clark, Associate Justice, Retired,* and Heaney, Circuit Judge.

Mr. Justice Clark

This appeal involves a claim for refund of $44,553.35 in federal income taxes paid by Elot H. Raffety Farms, Inc., a Missouri corporation, in the taxable years ending March 31 of 1964, 1967, 1968, 1969, and 1970. The United States District Court for the Eastern District of Missouri granted recovery. We reverse.

From the record, it appears that in early 1965 taxpayer, through its president and principal stockholder (Elot Raffety),

* Associate Justice Tom C. Clark, United States Supreme Court, Retired, sitting by designation.

agreed orally with L. D. Joslyn, a Missouri attorney, and the Rolwing-Moxley Company (the "Missouri partners") to conduct contton farming operations in the Republic of Mexico. They agreed that Raffety Farms would own a one-half interest in the enterprise and each of the other partners would own a one-quarter interest. Elot Raffety himself would act as the manager.

When it was discovered that Mexican law effectively prohibits farm operations by foreign nationals, attorney Joslyn employed Mexican counsel and instructed him to take whatever steps were necessary to enable them to farm there legally. Shortly thereafter, the Mexican lawyer organized *El Sombrero Sociedad de Responsibilidad Limitada* to conduct the farming business. Under its charter, *El Sombrero* was authorized to lease land, to process cotton, and in general to do all lawful acts related to an agricultural business. The business capital was fixed at 3,000,000 pesos to be provided by three Mexican organizers; the number of members of the company was limited to twenty-five; and the business was to be conducted by an administrator, Louis Vargas Nunez. No conveyance or assignment of any interest in *El Sombrero* was ever made to the taxpayer, nor did *El Sombrero* in fact ever issue any stock. The three Mexicans whose names appeared in *El Sombrero's* articles of organization never contributed any capital to the business, nor did they perform any services for which they were paid by the taxpayer.

During the taxable years in question, taxpayer and the Missouri partners put up substantial sums of money towards the cost of operations of *El Sombrero*. Taxpayer advanced $200,000 in 1966 and an additional $22,000 in 1967; Joslyn and Rolwing-Moxley matched those amounts. In exchange, however, no notes were issued by *El Sombrero*; there was no provision for interest; and no interest was paid. No security was established for the money so advanced. There was no fixed maturity date for repayment; indeed, no money so advanced was even required to be repaid, and none was repaid.

In the summer of 1965, Luis Vargas Nunez, acting in his capacity as administrator for El Sombrero, executed some 30 leases for farming land on the east coast of Mexico near Tampico, totalling thousands of acres. A few months later, in April of 1966, Raffety moved to Mexico and commenced operations. In the name of *El Sombrero,* he opened and maintained bank accounts, contracted for goods and services, and borrowed almost half a million dollars from Cook & Company, signing the promissory notes on *El Sombrero's* behalf. From the first, however, adverse fortune plagued the business.

Approximately 7,300 acres of cotton had been planted and had come up when Hurricane Inez struck in the first week of October, 1966, leaving less than 600 bales of cotton harvestable. The next year, after an initial dry season, crops were just coming up when Hurricane Beulah hit, drowning the cotton and making the acreage impossible to cultivate. Turning to safflower as a wintertime stopgap, Raffety planted the crop in November and December of 1967, but by the time it was harvested in the Spring of 1968, financial difficulties had caught up to *El Sombrero,* forcing the company to cease operations. Since payments on the Cook & Company loans were overdue, that creditor sued in Mexican court and obtained a judgment for $95,052.78 against *El Sombrero* as an organizational entity.[1] At the trial both Raffety and Senor Nunez appeared on behalf of *El Sombrero.*

Taxpayer never recovered its original advances to *El Sombrero.* Subsequently a complaint was filed in federal district court seeking a refund on income taxes paid between 1964 and 1970, and contending, alternatively, that the losses were deductible from income as:

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[1] Having guaranteed payment of the notes for *El Sombrero,* Raffety was made a party to the litigation, and his private airplane was temporarily seized when Cook & Company levied on the company's assets. It was apparently returned subsequently.

(1) operating losses under 26 U.S.C. § 165(a);

(2) bad debt losses under 26 U.S.C. § 166(a)(1); or

(3) ordinary business expenses under 26 U.S.C. § 162(a).

In response the Government argued that the advances were simply contributions to the capital of an "association" taxable as a corporation and must be characterized as capital losses under 26 U.S.C. § 165(f).

In a memorandum decision filed December 27, 1973, the district court found as follows:

> Although this *S. de R. L.* is an association taxable as a corporation under the Code, the Court is of the opinion that it must be disregarded for tax purposes as it was but a passive entity.
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> * * * * * * *
>
> The *El Sombrero S. de R. L.* was not organized for the purpose of avoiding taxes. Rather, it was organized upon the advice of Mexican legal counsel to allow the Missouri partners to farm in Mexico without being in violation of Mexican law. However, the *S. de R. L.* performed no substantial business function.

The court drew attention to the taxpayer's regular business of farming in Missouri and concluded that the Mexican cotton-growing operation was no more than an extension of its existing business. The lost advances were therefore ordinary and necessary expenses, deductible under 26 U.S.C. § 162(a). We cannot agree with the trial court.

The district court correctly classified *El Sombrero* as a corporate entity, i.e., an "association" under the Code. The relevant rule is that:

> An unincorporated organization shall not be classified as an association unless such organization has more cor-

porate characteristics than non-corporate characteristics. [Treas. Reg. § 301.7701-2(a)(3).]

The key factors to be considered are continuity of life, centralization of management, liability for corporate debts limited to corporate property, and free transferability of interests. Treas. Reg. § 301.7701.2(a).

Under Mexican law, it is clear that *El Sombrero* did have more corporate characteristics than non-corporate ones. Its liability was limited to its capital; its management was centrally controlled in the hands of an administrater; its life was continuous for at least 20 years, without limitation by death or separation of any of the members; it was required to have an annual meeting and an annual accounting; the fiscal year was the calendar one; the liquidation of the corporation was to be handled by the manager or other person designated by the members; and there could be only 25 members. Although the members of *El Sombrero* did not formally enjoy the right of free transferability of interests, the organization must be treated as a corporate entity since it possessed the remaining characteristics. Nevertheless, as we noted above, the district court chose to disregard *El Sombrero's* legal form and to focus on its "passive" nature. We think this puts the shoe on the wrong foot.

Since any income tax deduction is a matter of legislative grace, the claimant bears the burden of proving that he comes within its provisions. *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943). In the business area, once a corporate entity has been identified, it may not be disregarded in respect to taxation if it was intended to "have some real substantial business function, or if it actually engages in business." *Jackson v. Commissioner*, 233 F.2d 289, 290 (2d Cir. 1956). Here, *El Sombrero* did have an intended purpose and did engage in business. Indeed, it was the *sine qua non* of the Missouri group's being permitted to farm in Mexico. Without it, not one acre of land could have been leased, not one dollar borrowed, not one field plowed, nor one seed planted. It was the business entity through which the entire enterprise functioned and in whose name its operations were performed. As the Supreme Court has stated in *Moline Properties v. Commissioner*, 319 U.S. 436, 438 (1943):

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be *to gain an advantage under the law of the state of incorporation* or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. [Emphasis added.]

Cf. Omaha Public Power District v. O'Malley, 216 F.2d 764 (8th Cir. 1954).

In its brief, taxpayer argues that *El Sombrero* was "a fictional farce" that conducted no business operations itself. In particular, appellant stresses that Nunez, the so-called "administrator" of *El Sombrero*, had absolutely nothing to do with the operations of the business in Mexico. Taxpayer states:

> Luis Vargas Nunez did not handle the business of *El Sombrero*. There was no accounting or administration made annually and when the business was liquidated in 1968, it was not carried out by Mr. Nunez. Nunez had nothing to do with the management of the farming business and the three Missouri partners had equal voice and control in the management of the partnership affairs.

The bald facts of the record are to the contrary.

El Sombrero obtained and signed, through its administrator Nunez, leases on the 7,300 acres of land on which it conducted farming operations in Mexico; it received and paid out the funds (including those paid in by Raffety Farms and now claimed as deductions) used in the Mexican operation; it contracted for goods and services, bought machinery, and created a line of credit; it negotiated loans; and, finally, when the end came, it suffered a suit by Cook & Company in the Mexican courts in which administrator Nunez appeared for the company. While it is true that Elot Raffety personally supervised the actual farming, the entire operation was conducted in *El Sombrero's* name.[2]

The record disproves that *El Sombrero* was, as taxpayer insists, "a sham and a dummy organization" created for the purpose of evading Mexican law. On the contrary, it emerges as a viable, commercially active company operating on a mil-

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[2] The documents in this case make unmistakably clear that the parties perceived *El Sombrero* as a separate entity. For example, on May 17, 1967, attorney Joslyn (one of the Missouri partners) wrote to one John Baldridge of Tampico, Mexico, regarding acquisition of land by the company, saying:

> Sombrero has continued to prepare this farmland since its first oral agreement was reached in Tampico and has expended much money, time and effort thereon.

Moreover, the contract for establishing credit with Cook & Company, signed by Luis Vargas Nunez, as administrator of *El Sombrero,* and Elot Raffety, as guarantor, specifically designated *El Sombrero* as "The Grower", not Mr. Raffety. The tenth paragraph of this document obligated the grower "to continue delivering to the company [Cook] . . . the crops and fruits". And the eleventh paragraph obligated the grower "to sell to the company . . . the entire cotton crop. . . ." Furthermore, by letter to Cook & Company on September 17, 1968, Elot Raffety himself, representing El Sombrero, requested "a full accounting of the relationship between *El Sombrero* and your Company" and notes that Cook has in its possession "a good bit of our machinery and undoubtedly have sold some of it but we have had no word as to either the detailed account or credits on it . . ." Significantly, the letter closes with the observation that "Mr. Joslyn wrote you asking for an accounting and he says he has heard nothing." The letter is signed "*Sombrero S. de R. L.*" on the typewriter and below it appears the name of "Elot Raffety".

lion-dollar scale in Mexico which afforded to its true owners complete protection from personal liability. Taxpayer may not escape liability in a foreign nation's courts under one theory and then seek an advantage in this nation's courts by contending its opposite. That *El Sombrero* may not have been operated in complete accord with Mexican law or its charter is, at this late date, an irrelevancy.[3]

Alternatively, taxpayer urges that *El Sombrero* be viewed as, at most, an agent or nominee for the Missouri partners and that the losses are therefore attributable to the latter. We must reject this contention, for nothing in the record suggests that *El Sombrero* acted in the name of Raffety Farms, Joslyn, or Rolwing-Moxley in the conduct of its affairs with third parties. *See Harrison Property Management Co., Inc. v. United States,* 475 F.2d 623 (Ct. Cl. 1973).

Since the entity status of *El Sombrero* must be recognized, appellant's three claimed bases for deductions must accordingly be rejected. Raffety Farms paid the $222,000 at issue into the Mexican venture as a start-up expense and received a pure equity interest in *El Sombrero* proportionate to that contribution; no intent to repay or other indicia of a loan existed. Unquestionably, this capital investment may not be characterized as a "debt" under the bad debt loss provision of 26 U.S.C. § 166(a)(1). Further, we cannot accept the claim that *El Sombrero* was a mere extension of taxpayer's on-going farming activities in Missouri; it had no relationship with Raffety Farm's other agricultural operations. *El Sombrero* was a separate and distinct enterprise operating in a foreign country and in conjunction with other parties. Its expenditures for labor, equipment, and leases

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[3] So too, it is unavailing to appellant that the Missouri partners believed that they were only forming a limited partnership. The status of a taxpayer is determined not by what the taxpayer thought, but by the terms of the instrument which created it. *Wholesale Adjustment Co. v. Commissioner,* 88 F.2d 156 (8th Cir. 1937).

cannot be characterized as taxpayer's ordinary and necessary business expenses under 26 U.S.C. § 162(a). *Hagan v. United States*, 221 F.Supp. 248 (W.D.Ark. 1963), and *Lutz v. Commissioner*, 282 F.2d 614 (5th Cir. 1960), on which appellant relies, are therefore inapposite. The losses sustained by the Mexican operation are *El Sombrero's* alone, and, since taxpayer's interest in that company was a capital asset, may be deducted under 26 U.S.C. § 165 only to the extent allowed in §§ 1211-1212. *See* U.S.C. § 165(f).

The judgment is reversed.

GIBSON, Chief Judge, dissenting.

I respectfully dissent. While this case presents a close question, to me the Mexican entity, *El Sombrero*, was not a corporation and should not be treated as a corporation for tax purposes because it served no business function other than to enable the taxpayer to operate in Mexico. The taxpayer and its associates sought to carry on a profit-making venture as a partnership[1]

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[1] The "Missouri partnership" was formed in 1965 by oral agreement between three partners:

(1) the taxpayer, Elot H. Raffety Farms, Inc., a Missouri corporation engaged in farming in Missouri and Illinois, acting through its president and principal stockholder, Mr. Raffety (½ interest);

(2) Mr. L. D. Joslyn, a Missouri attorney (¼ interest); and

(3) Rolwing-Moxley Company, a corporation which Joslyn partly owned, engaged in producing cotton and other farm products (¼ interest).

The partnership was formed solely for the purpose of conducting farming operations in Mexico. The three partners agreed to share the profits and losses of their Mexican venture in proportion to their interests (½, ¼, and ¼ respectively). They considered themselves to be general partners having equal shares in management and control but delegated authority to Mr. Raffety to administer the Mexican operations personally.

Of the three partners, only the taxpayer corporation, Elot H. Raffety Farms, Inc., is a party to this litigation.

and were advised by Mexican counsel that formal creation of a "limited liability company" would be legally required for conducting business in Mexico. Even after counsel created the entity, however, it was operated as a partnership in every respect. The sole purpose of the Mexican entity was to provide an assumed name to enable the Missouri partnership to operate lawfully in Mexico. Tax avoidance played no part in the taxpayer's decision to create it.

The majority's decision in this case is another application of an anomalous principle under which the taxpayer always loses. If the substance of the transaction favors the Government, we look to substance (which we should); if it favors the taxpayer, we ignore it and look to form. It is improper in this case to impute corporate characteristics where there were none so as to deny the claimed operating loss of what was obviously a partnership venture. Whenever taxation is allowed to depend upon form rather than substance, "the door is opened wide to distortions of the tax laws." *Landa v. Commissioner*, 211 F.2d 46, 50 (D.C. Cir. 1954). Here, as elsewhere, the decision should turn on substance regardless of the outcome. *Estate of Smith v. Commissioner*, 313 F.2d 724, 730 (8th Cir. 1963).

I believe the entity as it was actually formulated and used by the partners did not possess sufficient corporate characteristics, even viewed under the Treasury Regulations cited by the majority, to warrant limiting the taxpayer to capital loss deductions by labeling this nebulous entity a corporation. It was in reality no more than a sham. None of the Missouri partners subscribed to the Articles which created the entity; they couldn't even read the Spanish language of the Articles, and were not informed of their specific contents until the IRS provided them a translation. They were issued no stock, notes, assignments, or other conveyance evidencing their interests in the entity. Nor did they receive any assurance of dividends, interest, security or a fixed date for repayment of their advancement of operating funds.

Moreover, none of the Mexican subscribers (fictional owners) made any actual investment in the partnership or Mexican entity and only one participated in its affairs. Indeed, they were practically unknown to the Missouri partners and no money was invested by the partners in their behalf. The figurehead administrator's activities appear to have been limited to signing documents with which he was unfamiliar or uninterested. He did not conduct the 1968 liquidation of the entity as the Articles purported to require. Nor were any required annual meetings conducted or accountings rendered. In sum, the entity was never capitalized or managed according to the provisions of its organizational Articles.

Three of the four characteristics relevant under Treas. Reg. § 301.7701-2 (1960), as amended by T.D. 6797 (1965), if present at all in the Mexican entity, existed in form only. First, while the entity purported to enjoy continuity of life by withstanding death or separation of any of the fictional members, the portion of the Articles treating the subject failed to provide for other contingencies such as bankruptcy or insanity of a member which might otherwise cause dissolution of a partnership. And, of course, the investing Missouri partners themselves were in no way affected by the entity's Articles. They had no documented legal interest nor association with it and their partnership did not enjoy continuity of life. *See* Uniform Partnership Law, Mo. Rev. Stat. § 358.310 (1969).

Second, while the general partners formally appeared to enjoy limited liability shielded by the Mexican entity, they all in fact did not. Because of the entity's obvious fictional nature, the partners were apparently unable to borrow sufficient capital under its name alone without adding Mr. Raffety's personal guaranty. As a result, Raffety himself was ultimately held personally liable for some of the venture's debts in litigation in a Mexican court.

The third characteristic, centralized management, was not present because the fictional administrator merely performed ministerial acts as an agent under the direction of his principal, the Misouri partnership. Treas. Reg. § 301.7701-2(c) (3) and (4). Although the Articles purported to empower the administrator to transact any of the entity's business, in fact he had no authority to make business decisions on its behalf independent of the Missouri partners. The partners agreed from the start that they alone would share management and control of the venture equally with the understanding that Mr. Raffety would conduct the business and farming operations personally in Mexico, using the entity's name rather than his own. And while the entity itself extended no actual authority to Raffety to act on its behalf, the Missouri partnership surely did. As an example, Raffety personally drew all checks in the entity's name to pay the venture's farming expenses.

The final corporate characteristic, free transferability of interests, was present neither in form nor in substance. No shares of stock or any other evidence of equity ownership was ever issued to the Missouri partners or their nominees. The Government conceded that the interests of even the fictional owners of the Mexican entity were not freely transferable because the Articles contained restrictions. And if in reality the Missouri partners' interests in the entity were none other than their partnership interests, transfer of the interests was restricted under Missouri law. *See* Uniform Partnership Law, Mo. Rev. Stat. § 358.270 (1969). It thus appears that the association of *El Sombrero* had more noncorporate characteristics than corporate characteristics and should under Treas. Reg. § 301.7701-2 be characterized as a noncorporate entity.

It further appears that even if the concept of a taxable association is stretched to include the Mexican entity in this case, the District Court correctly concluded that the entity should be disregarded for tax purposes because it was altogether passive.

While the practice of disregarding a corporate entity is not to be lightly applied in any context, this case presents the proper exceptional situation that warrants it.

The entity here performed no substantial business function and actually engaged in no business. Its purpose, as the District Court found, was solely to allow the Missouri partners to farm in Mexico without violating Mexican law. Such a purpose cannot be considered the equivalent of commercial or "business activity" as that term is used in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943), because it is inert. Moreover, following its organization the entity did not itself carry on any business. Raffety's personal Mexican farming activities on behalf of the partnership, with no more connection to the entity than the use of its name, cannot be characterized as conduct of business by the entity. The test of conducting business under *Jackson v. Commissioner*, 233 F.2d 289, 290-91 (2d Cir. 1956), is the actual business functioning of the entity itself, if any, not the taxpayer's aim to be accomplished by using it. The entity here should thus be disregarded for tax purposes just as it was for all others, and the partners' operating loss recognized as their own, not merely as that of the Mexican entity. *See Paymer v. Commissioner*, 150 F.2d 334, 337 (2d Cir. 1945).

I would affirm the judgment of the District Court for the reasons stated by Judge Wangelin and would further hold that the Mexican entity was not an association taxable as a corporation.

A true copy.

Attest:

Clerk, U.S. Court of Appeals, Eighth Circuit.

APPENDIX D

United States Court of Appeals
For the Eighth Circuit

September Term, 1974

Elot H. Rafferty Farms, Inc., Appellee,
vs.
United States of America, Appellant.
No. 74-1392.

Judgment

Appeal from the United States District Court for the Eastern District of Missouri.

This Cause came on to be heard on the record from the United States District Court for the Eastern District of Missouri and was argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the judgment of the said District Court, in this cause, be, and the same is hereby, reversed.

And it is further ordered by this Court that this cause be and is hereby remanded to the said District Court for proceedings consistent with the majority opinion of this Court this day filed herein.

February 26, 1975

(See attached sheet for cost information.)

A true copy:

Attest:

/s/ ROBERT C. TUCKER
Clerk, U. S. Court of Appeals, 8th Circuit
April 2, 1975

APPENDIX E

United States Court of Appeals
For the Eighth Circuit

74-1392 September Term, 1974

Elot H. Rafferty Farms, Inc., Appellee, vs. United States of America, Appellant.	Appeal from the United States District Court for the Eastern District of Missouri.

The Court having considered petition for rehearing en banc filed by counsel for appellee and, being fully advised in the premises, it is ordered that the petition for rehearing en banc be, and it is hereby, denied.

Considering the petition for rehearing en banc as a petition for rehearing, it is ordered that the petition for rehearing also be, and it is hereby, denied.

March 20, 1975